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Top management turnover and firm default risk: Evidence from the Chinese securities market

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ABSTRACT

China has moved rapidly from a socialist planned economy to a market economy. As a result, many enterprises in China are seeking talented top management to increase their performance and decrease their default risk. Studies abound regarding top management turnover and its relationship with firm performance, however, few studies have connected top management turnover with firm default risk. In China, a market with extensive financial fraud, firm default risk is an important factor and thus we explore this relationship in the Chinese securities market. Our results indicate that firms with higher default risk are more likely to change their top management in the next financial reporting period. In addition, following changes in top management, such firms default less than other companies.

1. Introduction

China has sustained a rapid rate of economic growth since the start of its economic reforms. The trials and tribulations of the reform process have been well documented (Cao et al., 1999; Gao, 1996; Groves et al., 1994; Lin and Zhu, 2001) and analysis of the effectiveness of these reforms has begun to appear in the literature (Allen et al., 2005). Following this trend, many academic articles have focused on China, examining topics such as the effect of foreign direct investment (Pingyao, 2002; Liu et al., 2002), the volatility of the stock market (Xu and Chen, 2001; Yeh and Lee, 2000), the effect of trading strategies (Kang et al., 2002) and the determinants of stock returns in the Chinese market (Bailey et al., 2003).

One of the most important policies for the Chinese securities market has been China's rapid transformation from a socialist planned economy into a market economy. Many state-owned enterprises (SOEs) are listed on the Chinese securities market and the majority shareholders of such firms are the Chinese government, which has relatively little experience in increasing firm performance. Accordingly, many studies have suggested that developing an improved system of managerial resource allocation that is responsive to market forces is important to China's economic reform (Groves et al., 1995). Groves et al. (1995) found that poor performing firms were more likely to select a new manager by auction, were required to post a

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higher security deposit and were subject to more frequent reviews of management contracts. Managers could be and have been fired for poor performance and higher default risk. They conclude that top management plays an important role in Chinese enterprises. Many empirical studies link top management turnover to firm performance and provide evidence to show that the likelihood of management turnover is negatively related to firm performance (Coughlan and Schmidt, 1985; Warner et al., 1988; Weisbach, 1988). Stiglitz and Weiss (1983) explored the termination of managers' contracts and found that the probability of top management turnover depends on current and past relative performance. Warner et al. (1988) also found that firms with low stock returns are more likely to change their top management. Coughlan and Schmidt (1985), Kim (1996) and Weisbach (1988) also report similar results.

Although, several studies have explored the relationship between top management turnover and firm performance, few have explored the relationship between top management turnover and the probability of firm default. Recently, many notorious accounting scandals, such as Enron and WorldCom, have forced the public to pay more attention to firm default risk. Corporate scandals in emerging markets are even more serious. In China, Sun and Zhang (2006) point out that about 20% of publicly listed firms have been convicted by the China Securities Regulations Committee (CSRC) for serious fraud or other scandals since the Chinese stock market was established in the early 1990s. Numerous cases of financial fraud have occurred recently in China, such as those involving the Chang An Information Industry Company and the Yuan Hua Company. Accordingly, in this study we explore the relationship between top management turnover and the probability of firm default in the biggest emerging market, China, which has extensive fraud and few mature securities regulations to protect investors.

In addition to finding that poor performing firms are more likely to have a new manager, many studies show that after replacing top management there is a potential improvement in firm performance, and subsequently firm value. Denis and Denis (1995) and Huson et al. (2004) document a substantial improvement in firm performance after the incumbent top management were removed following poor firm performance. Therefore, in our study we also assess the effect of replacing top management on firm performance.

Our study makes several contributions to the literature in this field. First, we provide evidence of the relationship between top management turnover and firm default risk, thus complementing the findings of prior studies. Second, we examine firms listed on the Chinese stock market to explore such relationships. Companies in emerging securities markets have higher default risk, therefore investors look for good top management to improve firm performance and reduce default risk. Accordingly, in this study we explore whether top management can effectively control firm default risk. Finally, we explore whether the probability of default decreases following the removal of the incumbent top management. This provides evidence regarding whether the appointment of new management is likely to improve firm performance. The empirical findings in this study should help investors to make appropriate investment decisions.

We use a random effects panel regression model rather than ordinary least squares (OLS) estimation in this study, because the panel regression model is able to supply more accurate inferences for the parameters and reduce any collinearity that may exist amongst the explanatory variables. Our results show that there is a greater prior risk of default when firms replace top management. Furthermore, after firms replace their top management, the probability of firm default is lower than for other companies.

The remainder of this paper is organized as follows. Section 2 presents the literature review and develops our hypotheses. Section 3 describes the data sources and empirical methodology. Section 4 provides descriptive statistics and presents the empirical results and analysis. The final section summarizes the conclusions.

2. Literature review and hypothesis development

2.1. Default risk and fraud

Dechow et al. (1996) and Johnstone (2000) indicate that firms with higher default risk have more incentive to use discretionary accruals to manipulate their financial statements, which is a type of fraud. In addition, many studies find that firms with a lower credit rating have higher default risk, thus they have more motivation to manipulate their financial statements (Bhojraj and Sengupta, 2003; Klock et al., 2005). Thus, firms facing higher default risk tend to use fraud to hide their default risk, and/or firms that commit fraud tend to go bankrupt once their fraud is detected, as happened in the case of Enron.

DeAngelo et al. (1994) find that managers use accounting choices primarily to reflect their firms' financial difficulties, rather than to attempt to inflate income. DeFond and Jiambalvo (1994) indicate that managers of firms that are approaching default respond with income-increasing accounting changes. In addition, many studies provide evidence that if a firm's covenant is violated, the lender has more opportunity to evaluate the borrower's performance. The managers of such firms then have more incentive to commit fraud and manipulate financial statements (Smith, 1993; Chen and Wei, 1993; Gopalakrishnan and Parkash, 1995; Dichev and Skinner, 2002). In summary, firms facing higher default risk tend to use fraud (such as manipulating their financial statements) to hide their high default risk.

2.2. CEO replacement and the probability of default

Many studies indicate that management turnover is negatively related to past firm performance (Coughlan and Schmidt, 1985; Warner et al., 1988; Weisbach, 1988; Gilson, 1989; Gilson and Vetsuypens, 1993). Desai et al. (2004) show that the